Expensive Labor Versus Cheap Capital

Anyone involved with the grain trade, international aid and development issues or agricultural economics in general is familiar with PL 480, otherwise known as the Food for Peace Program. First passed in 1954, this Eisenhower-era law, like anything of that time period that had "…for Peace" somewhere in its name, was designed to stick it to the commies on the theory we could buy friends around the world with food aid.

In practice, this turned out to be both a blessing for the hungry in cities and a nightmare for farmers in the countryside in recipient nations. Quite simply, farmers found it difficult to compete with a boatload of cheap or free American wheat, and as the distribution of that food aid was controlled by local politicians, it tended to go more to the politically favored than to more worthy targets.

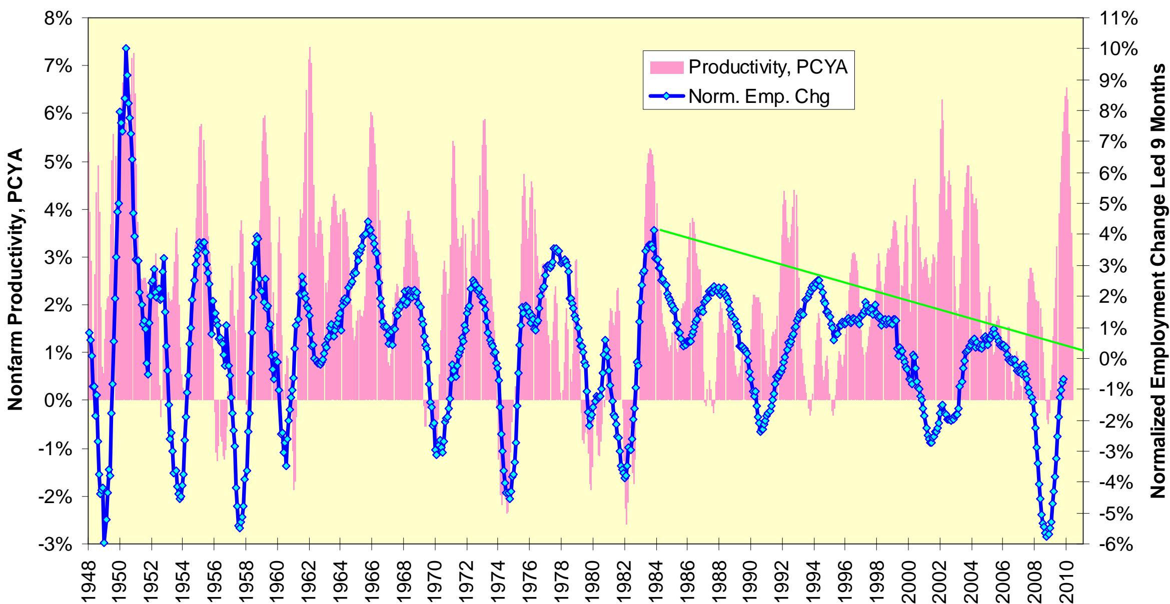
Let the record show the U.S. won the Cold War; this gave us the right to fill our store shelves with goods made in China and it gave the Chinese the right to own scads of Treasury bonds.

Competing With Cheap Capital

I bring this up to discuss one aspect of our rising and possibly intractable employment problem. All economic processes have certain factors of production such as land, technology, capital and labor. If you raise the productivity of labor, the amount produced per hour, you encourage employers to hire. If you raise the prospective cost of hiring, you encourage firms to shift their factor input from labor to other, cheaper factors such as capital and technology.

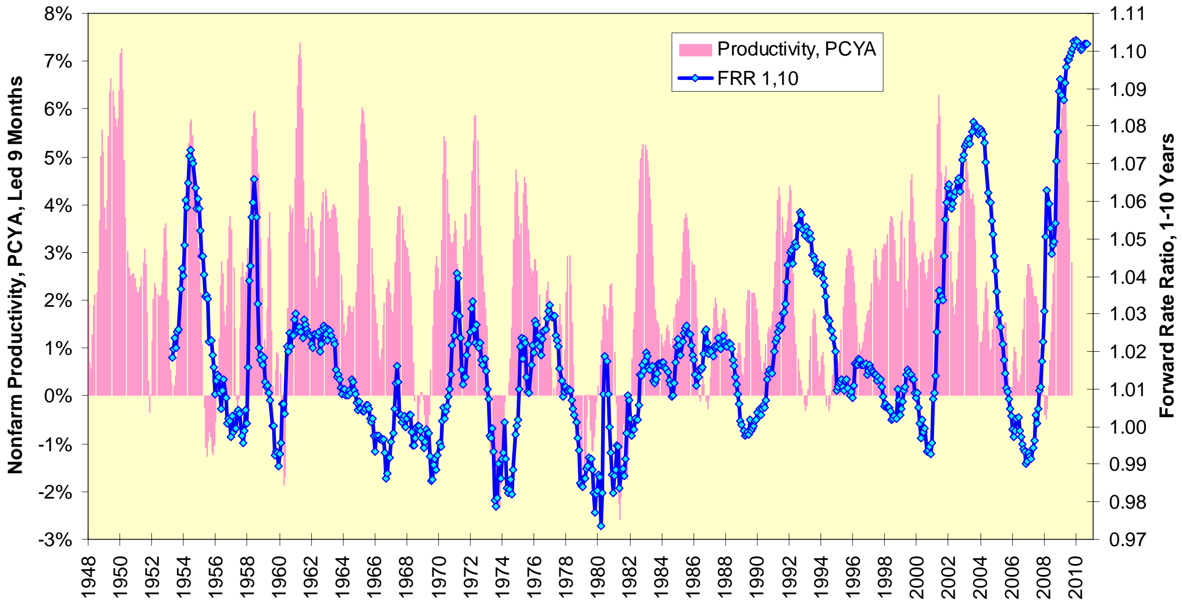
Even though the productivity of labor has been rising, its prospective costs have been rising due to factors such as healthcare costs and the vagaries of the American legal system. In contrast, the productivity of technology has been increasing at a much faster rate even as its costs have fallen; if you are reading this Website on a mobile device or a wireless laptop, consider this would have been science fiction stuff a generation ago.

The net effect has been a shift away from labor. As nonfarm productivity has increased over the years, changes in employment normalized to population growth have declined along the superimposed green trendline. This has been going on for more than a quarter-century, so I will presume it is not a passing fancy.



Now if we consider the Federal Reserve's rate-cutting campaign and how the cost of short-term operating funds has plunged toward 50 basis points while the cost of debt capital has fallen to just over 4.5%, labor has the same problem faced by our Third World farmer friends on the receiving end of a boatload of free wheat: How can you compete with free?

Ironically, the cheap money and improved technology have contributed to the rise in labor productivity. Note how he steep yield curve as measured by the forward rate ratio between one and ten years, the rate at which we can lock in borrowing for nine years starting one year from now, divided by the ten-year rate itself, leads productivity growth. Cheap capital makes it possible for firms to endow their remaining workers with more productive assets and to produce more output with fewer workers.



These are very long-term secular forces. Even as the economy recovers, do not expect a massive surge of hiring until the relative costs of production start to move in favor of labor again. That could be a very long time.